JOINT ECONOMIC COMMITTEE
REPUBLICAN SENATE STAFF

Recent Economic Developments

Senator Robert F. Bennett

Vol. 1, No. 5
Nov. 13, 2002

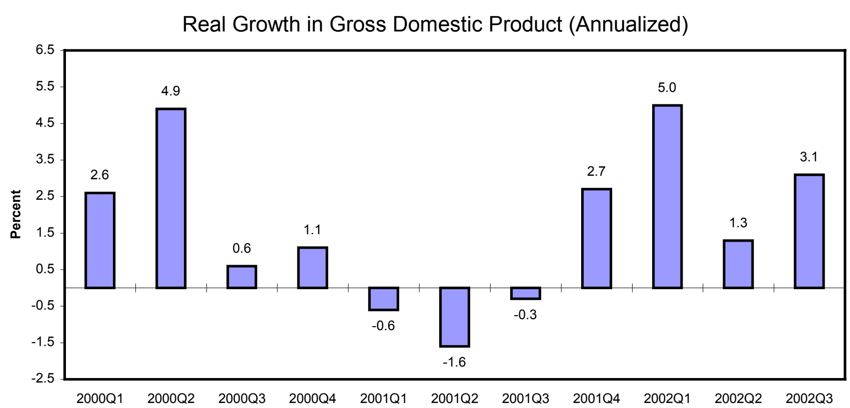
WATCHFUL WAITING

The economy has now been growing for one full year, at an average real rate of more than 3.0 percent. Consumer spending remains resilient, but has shown some signs of possible weakening. Businesses have been in a period of watchful waiting—reluctant to hire more workers and invest in more capital—because of ongoing geopolitical, economic, and financial uncertainties. Vibrant growth will require increases in business spending. Economic fundamentals do point to an accelerating recovery in 2003, but reasons for caution persist.

Reasons for Optimism

- **GDP Growth** for the third quarter was 3.1 percent according to the latest estimates, continuing the growth of the last year. Such growth is welcome, but is slow compared to many previous recoveries.

GDP Growth



Source: Bureau of Economic Analysis

- **Productivity** remains strong, confirming a trend that began in the mid-1990s and allowing GDP to increase despite slow employment growth. Productivity in the nonfarm business sector, for example, has grown at an average annualized rate of close to 5.0 percent this year.
- **Consumer Spending** grew 4.2 percent in the third quarter, driven by strong auto sales and continued growth in **Household Incomes**. **Consumer Credit** increased significantly in September. Though much of the increase reflected auto financing, credit for other purchases also grew substantially, suggesting that consumers may have a more positive outlook than recent consumer confidence data indicate.
- **Investment** by businesses in equipment and software showed healthy growth in the third quarter; however, investment has slowed in recent months. Lean **Inventories** suggest

that inventory investment could pick up in the near term. Future increases in business investment in capital goods are essential to take weight off consumers in sustaining the recovery.

- **Long Term Interest Rates** remain low, and may fall further given the recent cut in short term rates by the Fed. Low mortgage rates have helped homeowners refinance their mortgages, lower their monthly payments, and increase other spending. Reductions in corporate interest rates should encourage new investment.
- **Inflation** remains under control in both consumer and producer prices.

Reasons for Caution

- **Private Forecasters** have been lowering their estimates of fourth quarter growth, reflecting concern about consumer and business investment spending. The Blue Chip consensus, for example, expects only 1.6 percent growth in the current quarter; however, growth in 2003 is expected to rebound to 3.0 percent or more.
- **Labor Markets** continue to be sluggish. Employment fell slightly in October and the unemployment rate edged up to 5.7 percent from 5.6 percent in September. However, unemployment remains below its recent peak of 6.0 percent in April.
- **Capital Spending** slowed in recent months, after some signs of improvement in the spring and summer. Following strong growth in July, new orders of nondefense capital goods fell in August and September.
- **Manufacturing** has also shown some signs of weakness. After seven consecutive monthly increases, industrial production fell in August and September. Capacity utilization also fell slightly in those months. These data suggest that manufacturing may be stalling.
- Concerns about possible war with **Iraq** may be contributing to the reluctance of firms to hire more workers and invest in more projects.

Household Savings, International Activities, and the Federal Reserve

- The household **Savings Rate** increased in September, reflecting higher incomes and reduced consumption spending.
- The **Trade Deficit** grew in August as U.S. exports have been hampered by stagnant growth in the economies of most major trading partners.
- The **Federal Reserve** cut overnight interest rates by one half of one percentage point at its November meeting. It also upgraded its assessment of future economic risks from negative (higher risk of economic weakness) to neutral (risks balanced between slower growth and future inflation). The interest rate cut should help boost the economy, while the neutral assessment of risks signals that additional rate cuts are unlikely in the near term. The Fed acted forcefully, but will now be in a phase of **Watchful Waiting**.